Local government borrowing in the Czech Republic

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In the Czech Republic, like in other countries in transition, decentralisation has provided new opportunities for local governments including the right to access credit markets through commercial loans and bond issues. Borrowing at the local level is especially crucial for countries in transition because of its role in local development and financing strongly undercapitalised capital stock, as well as building more efficient and democratically accountable local governments. Issues of intergovernmental structure and the institutional and legal environment have often led to less-than-optimal borrowing practices and local indebtedness in many municipalities that prevents decentralisation from having maximum developmental impact. Indebtedness in particular (Maastrich criteria) –but institutional / legal issues and structural problems as well- are of particular significance in the Czech Republic due to its intent to join the European Union in 2004. Recent reforms have attempted to address these issues with mixed success.

Territorial Administrative Structure

To set the context for our analysis of local borrowing and financing in general it is necessary to look at the structure of local governance since 1989. The Constitution establishes the Czech Republic as a unitary state with two levels of territorial self government. Ideally this was supposed to be made up of larger regions and smaller municipalities. Before 2001 however, the regions had not existed and their functions were partially performed by 77 district offices *(Okresní Úřady)*, which were primarily arms of the central state with no autonomy in the sense of self-governance. The municipalities are well over 6,000 legally classified bodies with autonomy over their assets and budgets, and with the legal entitlement to access public transfers and private capital markets. Up to date only the Central Government and Municipalities have participated in credit markets.

This intergovernmental structure had significant consequences for the ability of local governments to gain access to credit markets. Primarily, the municipalities themselves often fail to achieve economies of scale in terms of administrative capacity and creditworthiness. Municipalities are extremely horizontally diverse in terms of size, tax-base, and degree to which they have been effected by transition reforms. In principle, all municipalities have free access to all forms of borrowing, but in practice access to borrowing by small municipalities is hindered by low credit worthiness. As a result of this intergovernmental structure the largest municipalities have had access to international markets including bond issues while the rest of municipalities have borrowed primarily from domestic banks.

The Municipalities are often fragmented into entities of both efficient and inefficient sizes. The new 2000 reform only partially addressed this problem by creating a more administratively competent group of 14 regions (*Kraj,* NUTSIII). The new regions are funded completely by the state budget between their creation in 2001 and December 2002, but according to the constitution they are allowed to engage in borrowing activities. This fact strengthens the need for clear regulatory framework – whole new level of local government will enter the credit markets.

A unique characteristic of the Czech system of intergovernmental fiscal relations is that there is no clear policy instrument that deals with "fiscal equalisation transfers", which take into account regional differences in both tax capacity and expenditure needs. In addition, with the inability of municipalities, especially smaller ones, to achieve any significant level of tax autonomy the most important method available for financing local fiscal imbalances and investment needs has been to borrow from non-commercial sources in the form of grants from various ministries and agencies, and to participate in commercial credit markets.

Institutional and Legal Issues

The institutional framework that would allow the financial sector to co-operate with local governments efficiently is still being developed. Municipalities face high uncertainty about future revenue from state sources. Accounting practices are problematic, and the audit process, although compulsory for municipalities and regions, is more of a formal procedure.

There is no official monitoring or supervisory mechanism acting on local governments to prevent their financial crises and there is no procedure to impose central government management on municipalities in case they were led by their councils close or into insolvency. However, these are not the only factors impeding local governments from efficient access to the credit finance.

Municipal revenue is only partially derived from its share of taxes (which are shared with the central government) whereas the other part is received in the form of grants from the state level. However, there exist no clear rules for the distribution of these grants. Considering that only 55% of municipal budget is based on tax revenue and uncertainty of grants from the central government, the ability of municipalities to predict their revenue in medium run is severely limited. This obviously makes any sensible analysis of municipality's ability to take on a loan virtually impossible.

To date, there has been no implementation of a standard accounting system. Although general rules do exist, there is a lack of uniformity because of diverse interpretation and coverage of budget items. (e.g. operational expense as investment) by different municipalities. The explanatory power of accounting reports is further limited by off-balance sheet operations. Among these operations the most common was the use of the municipal assets as collateral for commercial loans to private firms. This led to serious financial problems of several municipalities when a private firm was not able to fulfil its financial obligations. The positive step forward was made when such a practice was made in the framework of recent reforms.

Vast majority of audits of municipalities has been carried out by district offices for free. Municipalities can opt for audit to be performed by a private auditing firm, but in this case they would have to pay for it from its own budget. The high costs of independent audits are particularly prohibitive for small municipalities. Thus the use of independent auditors is close to none and the administrative capacity of district offices to perform audits is obviously limited. Therefore even audited results of municipal accounting do not provide credible information. The situation will be analogous with new 14 regions where the free of charge audits will be performed by the Finance Ministry.

The balance sheets themselves (which we explained above are of limited use) are the only subject of audits. Although the central government does formally monitor the management of its own grants and subsidies, it does not monitor with on-sight checks how the municipalities actually spend these funds. The use of municipal tax revenue and funds coming from their own for profit activities are not the subject of monitoring at all. In other words, oversight of the actual use of these resources accounted for on the books is never performed and there is therefore little to prevent the misuse of state grants for private gain or to improperly finance the municipalities operating budget.

Since no on-sight performance audit is executed and local government reports do not include explanations for any deviations from approved budgetary targets, both budget execution and formulation is still a locally top-down process (only municipal council oversees budget formulation although approval does come from the assembly). In addition, achieving a higher degree of direct regulation is complicated by the Czech constitution that allows local government autonomy over their assets and budgets.

The standard operating procedure of the Ministry of Finance has been, that the debt of local governments may not exceed 15% of the previous year's revenue, otherwise they will not be considered for any subsidies from the central government. The 15 % threshold needs to be a subject of further analysis to which the LGI sponsored study should contribute. For some municipalities the limit may be set to low thus hindering their development for other it may be too much in order to prevent their financial difficulties.

Nonetheless, moral hazard on local level seems to be the most serious issue. Current monitoring and supervisory mechanisms of local financing are insufficient to prevent irresponsible and destabilising behaviour of local governments. A good example, how far this can go, is the perverse use of municipal assets as collateral for private loans. Thus, moral hazard takes mainly two forms – local populism and corruption. Buying political support with credit finance services had not been an exception. There has been a lack of regulation to stop conflicts of interest on the local government level.

In addition, the Bankruptcy and Composition Act does not include municipalities as a subject, but instead concentrates solely on private firms. Thus there does not exist any mechanism to cope with over-indebted municipalities or regions. A kind of bankruptcy procedure is needed. The potentiality of bankruptcy would also reduce moral hazard on the part of Commercial banks which were eager to provide credits to municipalities led by the Česká Spořitelna which itself provided over 30 % of total municipal commercial credit. Although the potential role of the central government as a lender of last resort to local governments should be clearly defined. There is no transparent legal regulation on who and when should be bailed out. There have been precedents when non-interest loans provided to municipalities by the central government were turned into grants or subsidies in case the municipality was in financial trouble.

There are more hindering legal regulations vis-à-vis access to credit finance. According to the Czech Commercial Code future revenues (even tax revenues) are not permitted to be used as collateral for commercial loans. This considerably hampers the ability of especially poorer municipalities to qualify for commercial fund, because only physical assets can be used outside of cash-in-hand as collateral. However, market control of local borrowing is of crucial importance. USAID contributed to the launch of municipal ratings performed by Czech Credit Agency, but only about 30 out of over 6000 municipalities receive actual rating so the impact of market discipline is only marginal. Other municipalities receive external feedback only from commercial banks – usually based on the low-value accounting reports.

To sum up, low quality and non-unified accounting accompanied by poor auditing cannot serve as a decision basis on credit manageability for financial institutions but most importantly for municipalities themselves. In the context of poor monitoring mechanisms from the side of the central government market discipline is insufficient to control and guarantee responsible and sustainable access and use of credit finance by municipalities.

Current State of Indebtedness

Low administrative capacity of local governments is a major result of a dearth of expertise in financial management. Municipalities have been unable to successfully predict revenues, pursue sound risk analysis, and to calculate costs of credit. It is fair to conclude that municipal credit management is still in a stage of early development in the Czech Republic despite efforts by development organisations.

Roughly 65% of all municipalities are carrying some form of debt. The pace in which the indebtedness of local governments increased is considerable. Local indebtedness increased in nominative terms by a factor of 15 between 1993 and 2001. Whereas the steepest growths occurred till 1997, i.e. during the restrictive fiscal policy executed by the central government. This illustrates the possibility of local governments to exercise fiscal policies contrary to those of the central government. However, once considerable (the central public debt was converging to zero) local debt was put into shadow by increasing public debt on the national level due to the course of social democratic government since 1998.

Many small and middle-size municipalities are already facing serious financial problems. About 10 municipalities are in a state of insolvency and there has been one case of forced auction in the small municipality Rokytnice nad Jizerou, where municipal assets were sold. Often the cause of the serious situation is that municipalities owe the state for non-interest and subsidised interest loans from different various state government development sources (Environmental Improvement Fund, Ministry of Finance, Ministry of Regional Development etc.) When they are not able to finance the state loan they use commercial credits, which exacerbates the situation. Or sometimes the reverse is true, and municipalities use *all* of their state grants only to pay the interest on their commercial loans.

The credit finance for local governments will be even of higher importance. Currently municipalities are running out of assets to privatise. Most of these assets were the shares in the distribution companies which municipalities were granted in the transformation process. Since there was no regulation on the use of privatisation revenue, not all of the acquired privatisation funds were used for capital investments. Without available privatisation funds to subsidise the operating budget, previous budget items will be put under more pressure. The needs and incentives to borrow will thus increase because of a lack of privatisation revenue.

In the framework of the Czech accession to the European Union there are available pre-accession funds both for municipalities and regions. The funds could be used to co-finance various development projects, mostly capital investments. However, the transparent and efficient management of local finance is crucial in order to qualify for the pre-accession aid, which is even more needed due to the recent floods that hit the Czech Republic.